United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING EN BANC

Signed copy

74-1221

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

CITIES SERVICE COMPANY,
Plaintiff-Appellee-Appellant,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant-Appellee

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

PETITION FOR REHEARING WITH SUGGESTION OF REHEARING IN BANC

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IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 74-1221 and 74-1490

CITIES SERVICE COMPANY,

Plaintiff-Appellee - Appellant,

v.

UNITED STATES OF AMERICA,

Defendant-Appellant - Appellee

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

PETITION FOR REHEARING WITH SUGGESTION OF REHEARING IN BANC

To the Honorable United States Court of Appeals for the Second Circuit:

Pursuant to Rules 35 and 40 of the Federal Rules of Appellate Procedure, the United States, appellant herein, respectfully petitions for a rehearing of the divided decision of this Court herein, and suggests the appropriateness of rehearing in banc. The matter is one of exceptional importance because (1) questions of bond discount, characteristically involving very large amounts, are of particular

significance to the revenues, (2) the decisions of this Court, whose jurisdiction includes the major financial center of the nation, are of unusual significance on questions of corporate finances, and the tax consequences thereof, and (3) a divided panel has disagreed concerning the scope of the recent and leading decision of the Supreme Court on bond discount arising from an exchange of debentures for preferred stock and on the significance of earlier decisions of the Supreme Court concerning the finality and effect of findings of the Securities and Exchange Commission in reorganizations under the Public Utility Holding Company Act of 1935.

The factors that the majority of the Court have overlooked or misapprehended are:

(1) The basis and reasoning of the Supreme Court's decision in Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974);

(2) The effect and finality of the finding of the Securities and Exchange Commission, pursuant to Section 11(e) of the Public Utility Holding Company Act of 1935, 15 U.S.C. §79k(e), that the debentures issued by Cities Service Company in exchange for its then outstanding shares of preferred stock were the equitable equivalent of the surrendered and cancelled shares of preferred stock.

The reasons for these conclusions are as follows:

Pursuant to an order of the Securities and Exchange Commission under the Public Utility Holding Company Act of

1935 finding an amended Plan for the simplification of its corporate structure fair and equitable, and an order of the United States District Court for the District of Delaware enforcing the Plan (In re Cities Service Co., 71 F. Supp. 1003 (1947)), Cities Service Company on May 28, 1947, issued to its preferred and preference shareholders its 30-year 3% Sinking Fund Debentures in aggregate face amount of $115,246,950 in exchange for its outstanding preferred and preference (hereinafter "preferred") shares, which were thereupon cancelled. The aggregate face amount of the debentures equalled the stated value of the preferred shares, plus accrued and unpaid dividends, plus the call premiums of the shares. The Securities and Exchange Commission, having examined the financial condition of the corporation and the circumstances under which preferred dividends had, with one partial exception, been withheld since 1932 despite the fact that in recent years preferred dividends requirements had been more than earned, had found that the debentures were the equitable equivalent of the preferred shares, with their attendant rights. (25 S.E.C., pp. 597-602). Taxpayer claims, nevertheless, that the debentures were issued at a discount, and the majority of the Court has found that discount existed, measured by the difference between the face amount of the debentures and their market value at the time of issuance.

In Commissioner v. Nat. Alfalfa Dehydrating, 417 U.S. 134 (1974), the Supreme Court, reversing the divided decision of the Court of Appeals for the Tenth Circuit (472 F. 2d 796),

held that bond discount did not arise when the taxpayer corporation issued its debentures in exchange for, and retirement of, its previously outstanding preferred stock, despite the fact that the market value of the preferred shares was well below the face amount of the debentures. In doing so, it stated that (417 U.S., p. 147) "the relevant inquiry in each case must be whether the issuer-taxpayer has incurred, as a result of the transaction, some cost or expense of acquiring the use of capital".

The Supreme Court then set forth, in Part III of its opinion (417 U.S., pp. 147-151) the reasons why it rejected the Court of Appeals' assimilation of the exchange to an issuance of the debentures for cash, followed by use of the resulting cash to retire the preferred shares. It stated (417 U.S., p. 148):

> This argument, however, calls upon the Court to take two steps that we are reluctant and unwilling to take. First, it would acquire rejection of the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred. Second, it would require us to speculate about the market price and value to the corporation of the debentures in question had they been sold upon the open market.

The Court reviewed the uncertainties concerning value

and market prices in that case and noted (417 U.S., p. 149):

> Both the rationale and the wisdom of the Court's attitude toward such attempts at reconstruction of transactions are particularly well demonstrated in the present case.

In this case, the majority of the Court exactly reversed the Supreme Court's analysis. Because the recipients of the debentures could sell them on the New York Stock Exchange, the majority took this evidentiary difference to be controlling. But it is clear that to the Supreme Court the evidentiary factors only demonstrated the wisdom of the "established tax principle" against reconstruction of transactions, which was the controlling factor. Discount to the corporation depends not upon the price at which its debenture holders could sell their debentures, but upon whether the issuing corporation (417 U.S., p. 147) "incurred * * * some cost or expense of acquiring the use of capital."

Contrary to the majority's statement, the Government has not sought to reconstruct the transaction in the present case. Having rejected reconstruction in Part III of its opinion, the Supreme Court in Part IV (417 U.S., pp. 151-155) demonstrated why a corporation's issuance of debentures in exchange for its outstanding preferred stock imposed upon the corporation no "cost or expenses of acquiring the use of capital", and therefore gave rise to no discount upon the issuance of its debentures. The Court pointed out (417 U.S.,

pp. 151-152):

> From the perspective of the corporation, the transaction was the exchange of one form of interest or participation in the corporation for another. But the corporate assets were neither increased nor diminished.
>
> To be sure, upon the issuance of its debentures, NAD assumed a fixed obligation to pay at a date certain. * * * But again, when viewed from the corporation's perspective, * * * there has been no new capital acquired and no additional cost in retaining the old capital.

The Court concluded (417 U.S., p. 154):

> In sum, the alteration in the form of the retained capital did not give rise to any cost of borrowing to NAD. * * * It was able, instead, to obtain the preferred merely by cancelling the $50 obligation per share on its equity account and transferring that amount to its debt account.

These considerations, which demonstrated that no discount arose in the <u>National Alfalfa</u> case, are equally applicable here and equally demonstrate that no discount arose from the issuance of the taxpayer's debentures in this case. The majority sought to differentiate the cases by virtue of the fact that in the <u>National Alfalfa</u> case the debentures were issued in the face amount of the par value of the preferred shares while here the debentures were issued in the amount

of the stated value of the preferred shares, plus accrued and unpaid dividends and call premium. But this purported distinction is without substance. It ignores both corporate law and, more significantly, the findings and function of the Securities and Exchange Commission.

As of December 31, 1946, Cities Service Company had a capital surplus in excess of $22,000,000 and an earned surplus in excess of $39,000,000 over and above not only its stated capital but also the accrued and unpaid dividends on its preferred stock. (25 S.E.C., p. 578). As against the common stockholders, the only other interest in the corporation after the long-term debt was retired, the preferred shareholders had, as a matter of corporate law, a claim against assets equal to the amount of the dividends that had been withheld from them fully on a parity with their claim to assets in the amount of the stated value of their shares. But even more significantly in the context of this case, the Securities and Exchange, recognizing its duty to apply the full priority rule to the claim of the preferred shares (Otis & Co. v. S.E.C., 323 U.S. 624 (1945)), found that the debentures that were issued in exchange for the preferred shares were the "equitable equivalent" (25 S.E.C., p. 597) of the surrendered preferred shares. In doing so, it was the duty of the Commission to award to the preferred shareholders the investment or going-concern value of their securities. S.E.C. v. Central-Illinois Corp., 338 U.S. 96, 130-131, 139 (1949).

And its finding of equivalence, unless not supported by evidence, was not subject to review. S.E.C. v. Central-Illinois Corp., supra; Niagara Hudson Power Corp. v. Leventritt, 340 U.S. 336 (1951). No claim can be or has been made in this case that the findings of the Commission were not supported by evidence.

The findings of the Securities and Exchange Commission in this case establish the lack of any significant difference between this case and the National Alfalfa decision. When the preferred shareholders received debentures in the face amount of $115,246,950 they were receiving only and exactly the equitable equivalent of their interest in the corporation. The corporation therefore incurred no "cost or expense of acquiring the use of capital". The decision of the majority, finding that Cities Service Company incurred discount upon the issuance of its debentures overrode to that extent the finding of the Securities and Exchange Commission, contrary to the repeated mandates of the Supreme Court.

CONCLUSION

For the reasons stated above, the petition for rehearing should be granted, the judgment below should be reversed, and the complaint herein should be dismissed.

Respectfully submitted,

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JANUARY, 1975

CERTIFICATE OF COUNSEL

The undersigned counsel for the United States of America hereby certifies that the foregoing petition for rehearing is presented in good faith and not for the purpose of delay.

Gilbert E. Andrews

GILBERT E. ANDREWS

CERTIFICATE OF SERVICE

It is hereby certified that service of this petition for rehearing has been made on opposing counsel by mailing four copies thereof on this 10th day of January, 1975, in an envelope with postage prepaid, properly addressed to him as follows:

Thomas E. Tyre, Esquire
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Gilbert E. Andrews
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UNITED STATES DEPARTMENT OF JUSTICE

WASHINGTON, D.C. 20530

January 10, 1975

Address Reply to the Division Indicated and Refer to Initials and Number

SPC:GEA:EJBrown:blh
5-51-10753

A. Daniel Fusaro, Esquire
Clerk, United States Court of Appeals
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Re: Cities Service Company v. United States
(C.A. 2 - Docket No. 74-1221, 74-1490)

Dear Mr. Fusaro:

We enclose herewith for filing with your Court twenty-five copies of a Petition for Rehearing, with Suggestion for Rehearing in banc, in the above-entitled case.

We are today forwarding four copies of the Petition to opposing counsel, together with a copy of this letter.

Sincerely yours,

SCOTT P. CRAMPTON
Assistant Attorney General
Tax Division

By: Gilbert E. Andrews
GILBERT E. ANDREWS
Chief, Appellate Section

Enclosures:
25 copies, Petition for Rehearing

cc: Thomas E. Tyre, Esq.,
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